Economic Perspectives

Address by Governor Hermod Skånland at the meeting of the Supervisory Council of Norges Bank on 20 February 1992

At the time of my last annual address the international situation was infused with fear of the possible consequences of the crisis in the Persian Gulf. A few weeks later, after the swift military victory over Iraq, the mood swung from fear to confidence. Then, once the initial enthusiasm settled, confidence was reduced to hope, and, in the absence of an economic upswing, hope has been tempered by a substantial element of doubt.

Although, of course, the Norwegian economy has been affected by events in the international arena, it is equally affected by our failure to get the growth process started through domestic forces. Our response has been to focus economic policy on further stimulating such forces.

Neither the international nor the Norwegian economy appear to be functioning in the accustomed manner, as a result of a number of factors which I will try to elaborate on in the following.

Naturally enough, my starting point will be the international situation, and I will focus particularly on capital formation and the various sectors' financial position. Thereafter I shall turn homeward and consider how international experience can contribute to illuminating the situation in Norway. Since our interest in these issues is more than purely academic, I will view them both in relation to the employment problem and the persistent crisis in the financial system.

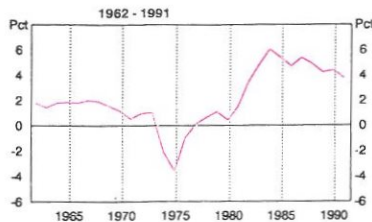
International economy caught between hope and doubt

During the period of adjustment after the oil price fall in 1986, the economy benefited – up to and including 1990 – from reasonably sound growth in the international economy, with diminishing budget deficits and current account imbalances.

However, as a result of the protracted upturn, capacity utilisation rose to a level which was incompatible with continued low inflation, and as from 1988 monetary policy was gradually tightened. In the United States the turnaround arrived early in 1990 and was augmented by the Gulf crisis. In the wake of the crisis followed an upswing which, however, was weak and for the time being disappointingly short-lived. A more lasting upturn is now not foreseen until after the summer. Parallels to this picture are to be found in Japan, albeit with the fluctuations around a higher growth rate, and in the United Kingdom where corresponding developments took place somewhat earlier.

In Europe as a whole the effect of tighter monetary policy and of the disquiet engendered by the Gulf crisis were for some time offset by the strong demand growth in post-unification Germany. Both the investment needs which unification uncovered and the income transfers from western to eastern Germany which it entailed prompted a highly expansionary fiscal policy stance. All the

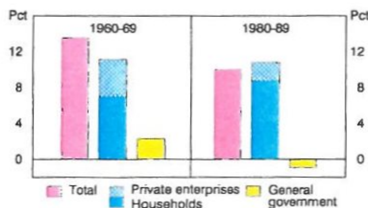
Chart 1 Real rate of interest in the G7 countries



After a period of low and sometimes negative real interest rates in the Group of Seven countries in the 1970s, rates rose steeply at the beginning of the 1980s, reaching unprecedented levels. The real interest rate is defined as the effective yield on long-term government bonds, using the two previous years' average growth in the consumer price index as a deflator.

Source: OECD

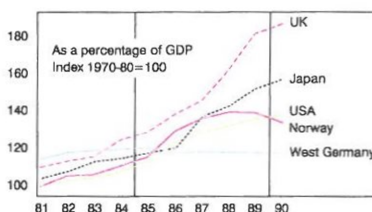
Chart 2 Saving in the Group of Seven countries as a percentage of national income



Between 1960 and the 1980s saving declined. General government saving accounted for virtually the entire decrease in the 1980s. The chart is based on the calculations for net saving, i.e. net of capital consumption.

Source: OECD

Chart 3 Private non-financial sector gross debt



In the USA, Japan and the United Kingdom private sector debt showed a steep increase. Continental Europe (represented by west Germany in the chart) showed a flat trend. Debt growth in Norway has followed the path of the first group. Debt in the form of shares has been excluded for all the countries surveyed.

Source: National sources

same, output growth declined substantially last year. It is a general expectation that growth in industrial countries will gather momentum after the setback, but will be slower than is usual in this phase of the cycle.

The economic setback experienced by our neighbours Finland and Sweden, two of our most important export markets, has been more dramatic, more on a par with developments in our own country after 1986.

A disturbing sign is that despite the cyclical downturn, real interest rates have remained high by historical standards. The yield on long-term government bonds in the major industrial countries (the Group of Seven) fell from an average of 4.1% for the 1980s to 3.7% in 1991, i.e. by only 0.4%. In comparison, the corresponding average in the 1960s was 1.8% and in the 1970s as low as −0.2%.

The industrial countries' debt trap

It is natural to seek the explanation for an increase in real interest rates in the relationship between capital supply and demand. Between the 1960s and the 1980s saving as a percentage of national income fell from 13.5 to 10% in the Group of Seven countries. Almost the entire decline, or 3.2%, was attributable to government saving which averaged a negative 0.9% in the 1980s. In other words the general government sector laid claim to private savings both to fund its own fixed capital formation and to meet its revenue deficit. The private sector saving rate remained more or less unchanged in the same period with some increase in the household saving rate and some decline in trade and industry.

Had there been a concurrent decline in investment activity, such a shortfall in saving need not have led to an interest rate increase. However, the rise in real interest rates is an expression of rather keener competition for savings, which is probably more in line with our impression of an increased need for investment. However, a need only has an economic impact when it translates into demand. And the interest rate is the factor which limits the actual demand for capital, thereby establishing a balance between demand and supply.

Increased credit demand may partially be met through achieving a more efficient mobilisation of private sector assets, thereby inflating both assets and debt. Dismantling of controls, new modes of financing and keener competition in financial markets made for easier access to credit, which had a significant impact on developments in the United States, Japan and the United Kingdom, resulting in higher indebtedness at real interest rates which were higher than past experience would lead one to expect. Highly geared businesses and households have been compelled to consolidate, reducing both consumption and investment, with creditors retrenching. Consequently aggregate demand has fallen, which in turn has led to surplus capacity and falling prices. The property market has been especially hard hit, bringing down the value of financial institutions' collateral and adding to their losses. Moreover, tighter requirements imposed by the supervisory authorities have made financial institutions more averse to extending new loans. However, credit demand has also fallen as a result of falling prices and a poorer economic outlook, and no-one today can state with certainty how far the slow growth in outstanding credit is due to a credit crunch and how much to weaker demand.

A similar trend in financial conditions has been witnessed in Finland and Sweden. Elsewhere in western Europe, there has been a far more moderate increase in indebtedness, with no comparable slump in the property market.

If higher-than-expected real interest rates and a strong increase in private sector net debt are an important factor underlying the present international situation, one has a basis for judging the prospect of a revival of growth. The public sector deficits can hardly be expected to diminish in the short term, especially in the absence of a cyclical upturn. Hence, a marked fall in interest rates is contingent on reduced demand for capital in the private sector. This would be an undesirable development. It may give more reason for hope if the process of financial adjustment in the private sector were soon to reach a point where the need to consolidate is no longer so manifest.

Another potential for stronger demand could lie in the possibility that countries in central Europe, and in time also countries farther east, will succeed in the transition to a market economy. If more orderly and credible economic and political conditions are achieved in these countries, high-yielding investment opportunities may arise. However, free capital movements will tend to raise the required rate of return in the established industrial countries too, with higher real interest rates as an outcome, at least until higher economic activity yields higher saving. Irrespectively, both Norway and the international community would be best served by a successful transition.

What, then, is the industrial countries' potential for achieving an upswing through their own economic policies? In the United States the Federal Reserve has repeatedly lowered lending rates. This policy has virtually played out its role, and its efforts are still unavailing. However, the time profile in monetary policy is such that the effects could well materialise with greater force in the period ahead. Japan has also lowered interest rates, albeit far more cautiously. In Europe the fear of inflationary pressure has prompted Germany to raise interest rates, and, in a world of free capital movements, the remainder of western Europe, which is so highly dependent on the German mark, has virtually no freedom of action in the conduct of monetary policy.

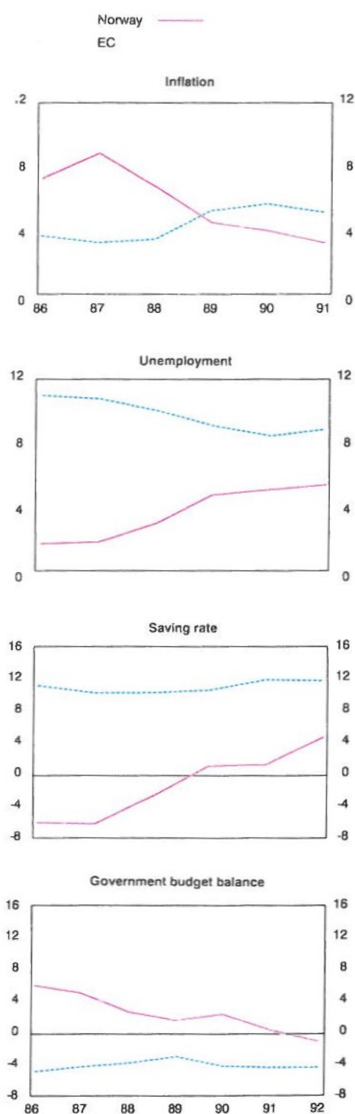
Not much more freedom of action is left in fiscal policy now that budget deficits have become a lasting phenomenon which has only been combated with immense effort in the 1980s. During the current recession they are at any rate increasing, and there is little incentive to relinquish more than an absolute minimum of what has been won through such great efforts.

Norway – more like others than we used to be

Our own country now differs less, for better and for worse, from other industrial countries than previously. We have brought down inflation to a level below the average for western European countries, and unemployment is no longer as far below the European level as it once was. The household saving rate is closer to the average of comparable countries, and the general government budget deficit is approaching the European average. The financial position of the central government is still far stronger than elsewhere, but with rising deficits this special position may not last for very long.

We find the same increase in private sector indebtedness in Norway as in the other countries I have mentioned, and around the mid-eighties it was even more pronounced. However, it was interrupted earlier, because the oil price

Chart 4 Inflation, unemployment, household saving rate and government budget balance



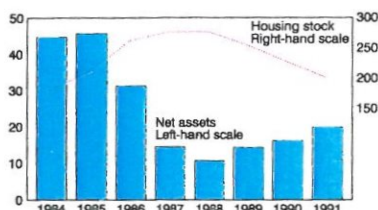
Since the mid-eighties a number of economic indicators commonly used in Norway have converged with EC indicators. Unemployment is measured using sample surveys. In Norway the AKU survey (labour market survey) is used. The government budget balance is measured as general government net lending in percent of GDP. The figures for 1991 and 1992 are estimates.

Source: OECD, Commission of the European Communities, Central Bureau of Statistics and the Norwegian Ministry of Finance

fall in 1986 — which provided a stimulus to other countries — compelled Norway to retrench. Moreover, because the boom had gone so far, the slump in domestic demand has been deeper and more protracted in Norway than elsewhere.

In this period Norway dismantled both domestic credit controls and restrictions on capital movements — one of the last industrial countries to do so. The tax system has been overhauled, first piecemeal and then through the more general tax reform effective as from the current year. These measures bring Norway closer into line with other countries, also in terms of the use of policy instruments. The measures have been prompted by the recognition that the workings of the economy have changed. However, the new situation has also meant that the expansionary fiscal policy of recent years has not yielded the results which would have been expected on the basis of experience.

Chart 5 Household wealth as a share of disposable income



In the years up to 1988 households' net assets declined without a concomitant weakening of their total wealth as the value of their stock of housing wealth rose as result of higher housing prices. Since 1988 the value of the housing stock has declined and households have built up net financial assets. The figure for net assets in 1991 are own estimates.

Source: Central Bureau of Statistics and own estimates

A nation averse to spending

This revision of fiscal policy was prompted by rising unemployment. Between the spring of 1989 and the end of fiscal year 1992 such measures gave an overall stimulus to private sector real income equivalent to 7.2% of GDP. However, the expected impact on demand has failed to materialise, and unemployment has continued to rise.

Households have chosen to use their increased real income to increase saving rather than spending, and in contrast to previous years saving is taking the form of an increase of net assets rather than investment in own dwellings. Several factors underlie the rising propensity to save. Although, in the period 1985-88, households decreased their ratio of net financial assets to disposable income, their overall wealth position was sustained thanks to the rise in the value of residential property. Since 1988 housing prices have fallen, and households have endeavoured to offset the resulting drop in their capital assets by increasing their financial assets. In many cases they are compelled to do so because dwellings have lost their worth as collateral. Additionally, the debt-servicing burden has grown, and financial assets yield a better rate of return than previously as a result of lower inflation and changes in the tax system. This has in turn affected housing prices and the value of residential assets.

Other factors also seem to have pulled in the same direction. Experience suggests that the increase in real disposable income witnessed in recent years increases the propensity to save, and greater income and job insecurity also increases the need for a financial cushion and reduced indebtedness. Doubts about how future generations will support us through the social security system have probably also played a part.

What happens ahead will be strongly influenced by the trend in housing prices. If they settle at their present level or thereabouts, an increase in real income in 1992 is far more likely than previously to be reflected in increased demand. Although the effect of the tax reform on real after-tax interest rates is an uncertain factor in this context, the reform has long been awaited and should have had ample time to affect housing prices.

Since the value of the housing stock is such an important determinant of household demand, housing construction as an employment measure may easily be counter-productive. A larger housing stock would depress prices in

the secondary market, and it would also take longer for such prices to rise to a level on a par with the costs of new construction, thus making construction of new housing commercially viable.

A household saving rate in the range 5-7%, as we expect for 1991 and 1992, is not particularly high by historical standards and even less compared with other countries. Saving rates in excess of 10% are fairly common outside the Nordic area. It is too early to say whether there are permanent reasons why people in our part of the world are less inclined than others to save, or whether our low saving rates are related to certain features of the tax system which have been substantially modified of late. In the longer term a higher saving rate should give no reason for concern. Indeed, a lower rate of net capital formation in the public sector could make it a necessity.

However, the failure of activity to pick up is not only due to households' aversion to spending: Mainland Norway's business and industry have also shown a disinclination to purchase goods and services for investment purposes. In part this is attributable to the surplus capacity in the commercial property market (greater even than in the housing market) with the result that there is little basis for investment in that area. But then neither is manufacturing industry showing any vigour of note. However, it should be added that there is a shortfall in manufacturing investment only when measured against the markedly high level of the mid-eighties. In relation to manufacturing industry's gross product, and compared with other industrial countries, Norway is at approximately mid-range. There is greater reason to be concerned over manufacturing industry's failure to employ more labour than its failure to employ more capital.

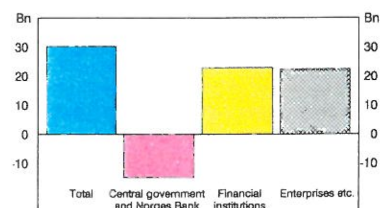
Where does the money go?

When household and enterprise income exceeds spending on goods and services, their net assets increase. Some of this increase, but still rather little, refers to net claims on the government, but most of it translates into an increase in net external assets. The country as a whole increased its net assets by NOK 30bn in the first eleven months of the year. However, the government concurrently increased its debt and Norges Bank reduced its external assets by altogether NOK 14bn, bringing the increase in the private sector's net external assets to all of NOK 44bn. This figure breaks down more or less equally on enterprises and financial institutions. It is quite natural under present circumstances for business and industry to consolidate their financial position. What is perhaps surprising is that so much of it takes the form of an increase in assets rather than a reduction in external debt.

It is of course gratifying that Norway is now running a substantial current-account surplus, in contrast to the period 1986-88. However, this surplus does not in itself give the state increased freedom of action in economic policy. To enjoy freedom of action the state must have funds at its disposal, and these are being reduced by present government deficits unless they are augmented by borrowing from the private sector or externally. The surplus on the current account has accumulated with private agents since they have refrained from employing the funds to purchase goods and services. Had they not refrained, the surplus would have been smaller and employment higher.

Any interest in higher employment prompts the following question: Why does the private sector prefer to use its savings to increase its net assets rather

Chart 6 Increased net external assets January — November 1991, in billions of NOK



The chart is based on balance of payments figures which show that enterprises increased net external assets by NOK 15bn. Revaluations based on exchange-rate changes are not included. Mainland enterprises accounted for almost the entire increase. Other sources show that the same sectors have reduced foreign currency borrowing intermediated by Norwegian financial institutions by NOK 7bn in the period. This is reflected in the external account by an increase in financial institutions' net external assets. In order to provide a more accurate illustration of the various sectors' external debt and assets, the NOK 7bn referred to above has been moved from the financial institutions to the enterprise sector etc., unlike in the external account. Financial institutions also reduced their foreign currency borrowing used to finance lending in domestic currency and increased assets.

Source: Central Bureau of Statistics and own estimates

than increase fixed capital formation? We have already given part of the answer in pointing to the private sector's need to strengthen its financial position, which is a temporary phenomenon. To the extent that this explains investment behaviour, fixed capital formation will again increase once the private sector's financial position has become strong enough.

However, if the explanation is that the funds are expected to yield a larger and safer return if invested abroad rather than in Norway, the problem is of a more lasting nature. It may be worthwhile examining this question more closely.

Searching for returns on investment

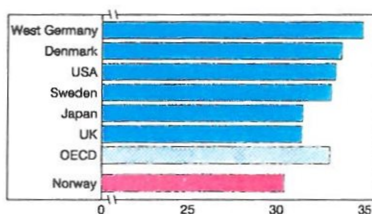
It is not easy to find comparable figures for rates of return on invested capital in various countries. However, for our purpose we do not need figures for the rate of return on all capital, which inter alia includes housing, roads and other public utilities. It is the rate of return on cross-border capital which is of significance, either in the form of direct investment in business and industry or portfolio investment.

Major disparities in yields in the bond market are unlikely to arise in the period ahead because capital movements will tend to smooth out such disparities. What disparities remain may be due to differences in liquidity in the various markets and different assessments of the stability of the individual countries' currencies. For instance, foreign bonds may be preferred to Norwegian bonds because the market in Norwegian government paper is still small, and because financial institutions' problems have severely reduced the liquidity of their bonds.

In the long run the rate of return on direct investment and share yields will be determined by profit margins in business and industry. For an initial comparison we can look at capital income's share of value-added in the corporate sector, i.e. that portion which is not used to cover labour costs. The figures are on a gross basis, i.e. before deductions in respect of capital consumption. The chart shows this as an average for the 1980s for Mainland Norway and for a number of Norway's major trading partners. It appears that profit shares in Norway were appreciably below those of other countries. The disparity was greatest towards the end of the period, following a sharp increase in labour costs in 1986-87, concurrent with an economic setback which affected Norway earlier than other countries. Had Norwegian business and industry used more manpower and less capital than other countries, this would explain such a disparity. However, we know that the opposite is rather the case, and that the disparity would be larger if the return could be measured directly against productive capital.

Calculations of the value of the capital stock come up against new difficulties and must be confined to sectors more amenable to comparison than business and industry as a whole. The OECD has published figures for some countries which enable us to calculate net investment income in relation to the value of depreciated capital stock in manufacturing industry. They confirm the impression that the rate of return on investment in Norwegian manufacturing industry is markedly lower than in other countries with the exception of the United Kingdom. If Norway is to increase employment in exposed activity, manufacturing industry will occupy a key position, even allowing for the potential which is undoubtedly offered by shipping and other export of services.

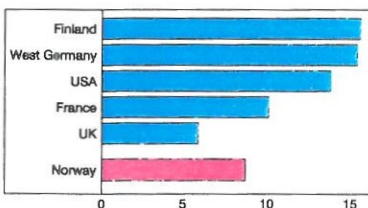
Chart 7 Capital income shares. Average, 1980s



The chart shows the share of factor income in business and industry which is not used to cover labour costs, in per cent of GDP at factor costs. Both are calculated in gross terms, i.e. including capital consumption. For Norway, shipping and oil activity is excluded.

Source: OECD and Central Bureau of Statistics

Chart 8 Rates of return in manufacturing. Average 1980s



Rates of return on capital are defined as operating result in per cent of capital stock. Both are calculated on a net basis, i.e. net of capital consumption.

Source: OECD

The rate of return in Norwegian manufacturing industry is not much higher than the real interest rate on risk-free assets. A risk premium of 2% or so provides little incentive for venture capital.

However, the relatively low rate of return on investment is by no means a new phenomenon in Norway, a country in which there was no shortage of investment in the 1970s and 1980s — even though we were in some doubt as to whether the return was adequate. Why is the current situation so different? To answer this question the household sector and business and industry must be considered separately.

Right up to the end of the 1980s, housing investment was by far the best form of saving for households. Inflation and tax rules meant that actual housing costs for house owners were highly negative. At that time it paid to borrow and invest in residential ownership. Inflation and the generous tax treatment of interest payments repaid the mortgage. During the 1980s, inflation was substantially reduced, resulting in higher real interest rates. However, the tax rules continued to keep down housing costs, which did not rise to zero until 1988. A continued decline in inflation and adjustments of tax rules have continued to push up housing costs in subsequent years. The tax reform will lead to some increase this year as well.

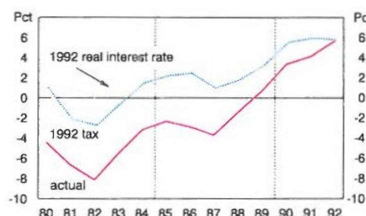
With today's real interest rates, housing costs would have been pushed up to zero as early as at the beginning of the 1980s, while today's tax system would have resulted in positive housing costs from around 1987. Both factors could have contributed to averting both the surplus housing stock which followed when real housing costs were brought closer into line with the price of the capital resources employed, as well as the subsequent slump in housing prices.

Where corporate investment is concerned the "required rate of return" is a useful concept. This is the rate of return required for a private sector investment to be profitable at the current interest rate level, rate of inflation and tax rules, but without any risk premium requirement incorporated. Here we shall confine our attention to the required rate of return on investment in machinery; however, the main features will be identical for investment in buildings.

At the very beginning of the 1980s investment in a piece of machinery would have been profitable even without a real return, and it was only towards the end of the decade that the required rate of return exceeded 5%. As in the case of housing investment, current domestic — or international — real interest rates would have pushed the required rate of return up towards recent levels at a far earlier stage and thereby moderated the pace of investment at a time when demand pressure was still high. The tightening of depreciation rules entailed by the tax reform has also contributed to raising the required rate of return; however, compared with higher real interest rates their impact has been small.

Given low real housing costs and low required rates of return, it paid to invest rather than to build up assets. Besides, foreign exchange controls provided little scope for foreign investment. Even so, for large sections of business and industry this did not represent any genuine limitation. It was of little conse-

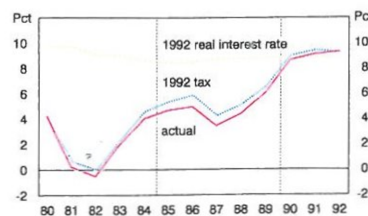
Chart 9 Housing costs



The chart shows the actual real costs of house ownership in the 1980s and what the costs would have been at today's real rate of interest and under the recently reformed tax system. The costs are expressed in per cent of invested capital. Estimates are based on debt-financed purchases, and the assumption that the expected nominal rate is equal to the average bank lending rate for this year. For 1991 and 1992 the interest rate used is the average interest rate for the first three quarters of 1991. The expected inflation rate used is the average growth in the GDP deflator in the previous year and this year. The highest marginal tax rates are used for each year.

Source: Norges Bank

Chart 10 Required rate of return. Investment in machinery



The rise in the required rate of return on investment in machinery in the 1980s is almost entirely ascribable to the increase in the real rate of interest. The assumptions concerning mode of financing, nominal interest rates and deflator are the same as in Chart 9. The method of calculation used is the method described in King and Fullerton (1984) "The Taxation of Income from Capital".

Source: Norges Bank

quence for households too, since, as mentioned, housing investments were more profitable, and after the devaluation in 1986 financial investment also yielded a better return at home than abroad.

But these conditions no longer apply, and will apply even less in times ahead. The new tax system has rectified the uneven treatment of fixed and financial assets, and free capital movement means that we have no scope for keeping capital inside Norway. With higher rates of return offered abroad, Norwegian enterprises will continue to invest abroad. However, the relative significance of portfolio investments can also be expected to increase should foreign share markets offer the prospect of a more favourable trend than Norway. Such investments are made not only by a small number of major investors, but also on behalf of hundreds of thousands of individuals who either leave it to the banks and life insurance companies to invest their savings or invest by way of unit trusts. And when domestic financial institutions come up against foreign institutions in a more open competitive climate, they will have to compete with the latter in offering the best investment opportunities.

We must face up to the fact that small depositors' capital has also been internationalised. Though some may find it regrettable, both practical considerations and international agreements prevent us from re-introducing restrictions on capital transactions.

Timing of the tax reform

The recently implemented tax reform has undeniably increased the required return on investment. Some people are therefore of the opinion that it should have been postponed.

It is easy to agree that from a cyclical viewpoint the main features of the corporate tax code should have been implemented at a much earlier stage when demand pressures were still high. On the other hand, it would have been inexpedient at that time to combine the reform with significant tax reliefs — without which it would have been difficult to revise the personal tax code, and this was in itself a prerequisite for the reform of corporate taxation. Independently of the business cycle, a tax reform implemented ten years earlier would not only have dampened the impact of the deregulation of financial markets, but also averted the present surplus capacity in the property market. With that opportunity foregone, it would have been most unfortunate if we had not, this time round too, implemented a tax reform in line with what has been or is being implemented in other industrial countries, and the necessity of which has been broadly agreed.

A reform involving a transition to a broader tax base and lower tax rates will always have a different effect on different groups, which complicates its implementation. Following ten years of preparation, the political situation now made its implementation possible. If this opportunity had not been seized and we had returned to square one, it is not very likely that a tax reform would have been achieved in this century.

Sometimes decisions must be adopted and implemented when the opportunity arises. In the long run the economy will have to adapt to the decisions taken.

Employment strategies

But not all the various facets of the economy show equal adaptability. Although the cost level in Norway was also relatively high in the early 1980s, inflation and the tax system produced a return on investments which was considered sufficiently high to make fixed capital formation profitable. Then, when inflationary expectations abated, the reduction in working hours in 1987 further raised the cost level, bringing hourly labour costs to a level above that of all our trading partners, and 25% above their average. Despite the statutory wage regulation of 1988-89 and what has been perceived as moderate wage settlements, hourly labour costs remained around this level in the ensuing years. A wage increase of around 5% in 1991 cannot have changed this picture significantly. New economic framework conditions seem to have had remarkably little impact on the wage level.

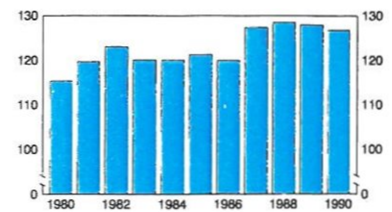
With our competitive position weakened, expanding market shares could hardly be expected to compensate for the effects of weaker domestic demand on employment. Instead the government turned to an expansionary fiscal policy. We have already discussed why these efforts to stimulate demand have not been very successful. Had we succeeded, under the present system of wage formation, in expanding demand in such a way as to approach full employment, we would again have experienced wage pressures resulting in a weakening of our competitive position. For near full employment to be maintained, the state would again have to compensate for the shortfall in demand resulting from the weakening of competitiveness. It should be evident that it is only a question of time before a policy based not only on large but growing deficits becomes unworkable. Oil revenues may allow us to extend the time horizon, but oil dependence can just as easily put a sudden stop to this fiscal policy approach today as in 1986. Moreover, there are fundamental objections to relying on the use of a stock of wealth and calling it income.

Fortunately this is not the only approach to remedying the unemployment situation. Employment growth can also be achieved through increased economic activity in the private sector. But this presupposes that it is seen as profitable to increase business fixed investment and production, and to do so in Norway. This in turn requires an expectation of markedly higher returns on business fixed investment than on financial assets and that the rate of return on investment in Norway is on a par with the level abroad. The relatively low profit share which I mentioned earlier reflects our relatively high labour costs. So far, we have mainly focused on the significance of labour costs for our market shares abroad and at home. Their significance in terms of our ability to compete for capital may become equally important in the future.

What practical possibilities there are for increasing the non-labour share of value-added and thereby the return on capital is another question. Nor can we choose solutions which will reduce government revenues without corresponding cuts in expenditure, since, as I have already stated, budget deficits cannot in the long run continue to increase.

It appears that in practice the best we can hope for under the present system is a growth path for labour costs that will slowly and gradually converge with that of our trading partners, in which case we can only expect an equally gradual and slow improvement in the employment situation. If, on the other hand, it were possible to reduce the nominal wage level or hold it constant over several years, the impact on employment would after a transitional period be appreciable and growing. The workforce would sustain a temporary loss

Chart 11 Labour costs in manufacturing. Index, trading partner countries = 100



Hourly labour costs in Norwegian manufacturing have hovered around 25% above the average of trading partner countries in recent years. This level is higher than the level registered in the first half of the 1980s. With wage growth in manufacturing sector at a good 5% in 1991 the picture remains virtually unchanged.

Source: The Technical Calculating Committee for Income Settlements, Report no. 1, 1992

in real income, but the effect would be dampened through disinflation which would bring consumer prices closer to what is found in other countries. Quite a bit could be achieved through a decrease in real wages corresponding to the increases we have bestowed on ourselves in the past two years. The jobless who re-entered the labour market would naturally enjoy higher real incomes.

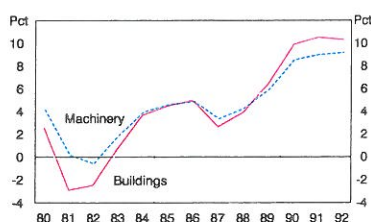
Perhaps zero wage growth might not be quite as unrealistic as I have indicated. In any event this year's wage settlement, with substantial growth in real income thanks to the tax reform, offers a rare opportunity which will be supported by lower inflation in the years to come as a result of international integration. Employment will, however, suffer if the gain provided by such integration were translated into higher real wages for the employed.

The present low inflation rate and high current-account surplus may give the impression of economic strength which provides little incentive for a radical change in economic behaviour. It is easy to forget that these positive signs are the direct result of the low level of activity and — as far as the external balance is concerned — record-high oil production. In the long run the objective of high employment cannot be achieved unless the price of labour is geared to this end.

Required rate of return and the crisis in the financial sector

Last year's bank losses and loss provisions reached record-high levels. The losses in the business and household sector, which are at the root of the banks' losses, are, however, not concentrated on that year alone. It is more natural to view the losses in connection with the rising required return on investment over a longer period which we pointed to as an explanation for the sagging level of investment.

Chart 12 Required rate of return. Investment in machinery and buildings



The required rate of return on investment in buildings followed the path of required returns on machinery, albeit on a somewhat steeper path. The calculations are based on the same assumption as in Chart 10.

Source: Norges Bank

The chart repeats the trend in the required rate of return on investment in machinery together with that for commercial buildings in central areas. The estimates are based on debt-financed investments, although the trend would remain about the same if other modes of financing had been used.

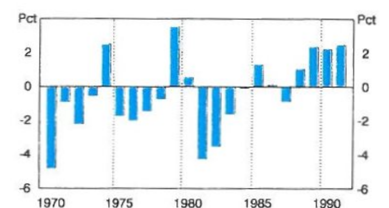
At the beginning of the eighties when the required rate of return was negative, quantitative credit control still functioned as brake on the amount of investment that could be generated by the low level of the required return. While the effectiveness of credit regulation waned and credit control was finally phased out, the required rate of return remained at a low level. As a result, investment boomed. But in 1988 the required return on investment rose dramatically.

Companies with robust equity capital and high earnings in relation to debt were able to weather this development, even if it meant that their most recent investments were loss-bearing under the new circumstances. But recent start-ups or firms having undertaken highly geared expansions were filing for bankruptcy in growing numbers. When collateral was realised it had to be sold at a value that would satisfy the new required rate of return. This in turn reduced the value of other collateral held by financial institutions as security for loans. The same conditions applied to fixed property held by financial institutions, whether it was for own use or repossessed for subsequent sale.

No simple formula exists for estimating losses stemming from a rise in the required rate of return. To some extent current loss provisions may be ascribed to the earlier tendency to underestimate losses and a somewhat short-sighted perspective on property values. The relationship between the losses and the dramatic rise in the required rate of return is nevertheless clear enough, and it is hardly a coincidence that the losses have been particularly heavy since 1988. Once the process is under way, individual losses will appear equally ascribable to falling sales, reduced earnings and unemployment.

As mentioned in the section on the international economy, the rise in the required rate of return and the problems it creates for financial institutions are not only a Norwegian phenomenon. The rise in the real interest rate level, however, occurred at a later stage in Norway, and the adjustment to an economy with a reasonable degree of price stability was quite sudden and occurred shortly after the deregulation of financial markets had made room for a substantial increase in gearing ratios. It is, therefore, not surprising that the impact on the financial industry was particularly severe in our country.

Chart 13 Real interest rate differential. Norway minus the Group of Seven countries



In the 1970s the real interest rate was generally lower in Norway than in the Group of Seven countries. The widest difference can be seen at the beginning of the 1980s when the rise in real interest rates from the very low levels in Norway lagged the corresponding increase in the G7 countries from the low levels in the 1970s. In recent years real interest rates have been higher in Norway than in the Group of Seven countries both as a result of higher nominal interest rates and lower inflation. The real interest rate is defined as the effective yield on long-dated government bonds, using the previous year's growth in the consumer price index as a deflator.

Source: OECD and Norges Bank

To what extent could a rise in the required rate of return have been avoided? It could not have been curbed by an inflation rate in excess of that of other counties. This would have necessitated further devaluations, and the nominal interest rate would have reached higher levels. With free capital movements our control over the real rate of interest is no greater over time than our control over nominal interest rates.

We could, however, have postponed the modernisation of the tax system. I have already mentioned the attendant risks, and the effects would have been limited anyway.

The root of today's difficulties lies in the imbalances of the past, rather than in our efforts to rectify them. Throughout the post-war period we have been disinclined to allow the real cost of capital to determine its market price to the final user. The transition to more realistic capital costs would necessarily give rise to problems. But these problems have only been deepened by postponing the transition.

The problems are intensified by a situation in which the share of capital income in business and industry is very low and lower than what was expected when debt was incurred. It is from this low capital income that the debt is to be served. As time passes, the crisis in the financial sector will increasingly reflect the crisis in business and industry. This does not mean that the losses sustained by business and industry, households or financial institutions were bound to reach today's level. They are also the result of an unfortunate business strategy and poor judgement. But this has been dealt with extensively earlier and is likely to be examined anew in ongoing studies.

Undesired ownership

Shareholders and bank employees were the first victims of the banking crisis. The banks' guarantee funds have also sustained losses, and so has the central bank which is now providing low-interest loans in an effort to help the banks increase their earnings. In 1991 the government also intervened heavily with support totalling NOK 15.5bn provided via the Government Bank Insurance Fund and the Government Bank Investment Fund. The government is currently the dominant shareholder in Norway's largest commercial bank

and has acquired in full the second and third largest Norwegian commercial banks. Three of our savings banks are currently operating on the basis of government-injected funds. The Government Bank Investment Fund is expected to supply additional capital to the banks in the course of 1992 in order to bring their capital ratios into compliance with the relevant capital adequacy requirements at the end of the year.

The Postbanken will also be established this year on the basis of the Postal Savings Bank. It will be given a larger degree of independence than its predecessor and will expand its traditional banking activities. By the same token, the Postal Giro will gain access to engage in some banking activity. Including Postbanken, the state now controls over 50% of the entire banking system. This situation is neither desirable, nor was it intended. The state will, however, only be able to withdraw if private investors are willing to take over. The incentive to do so can only be provided by expectations of competitive returns on bank shares and primary capital certificates. It is up to us, as the users of banking services or as taxpayers, to put the banks back into private hands. The burden we do not shoulder as users, we will have to bear as taxpayers. The earlier discussion about what costs the banks should carry and what they should pass on to the users is now of little relevance.

The government authorities face a staggering challenge with regard to devising an ownership strategy. A market economy relies on the assumption that institutions operating under approximately equal conditions are owned by independent agents and that the institutions can go bankrupt. Recent experience indicates that these assumptions do not hold for banks: the framework conditions are decided by the state itself in the case of Postbanken and the Postal Giro, and by the two Government Bank Funds for a large portion of the banking industry. If some institutions gain competitive advantages under these conditions, they will attract funds from the private sector, thereby diminishing the scope for other institutions to play their intended role in the now fairly state-owned Norwegian banking system. Alternatively, they could set prices and interest rates which are competitive with those set by institutions in a stronger position, thereby reducing profits and capital accumulation. This would, in turn, entail higher costs for the government when it decides to withdraw from the banking system, and we, as taxpayers, would have to foot the bill.

There is, however, no simple and permanent formula for defining equal framework conditions. On the other hand, piecemeal adjustments cannot be made if they weaken the incentives to increase profitability.

There are a number of obvious drawbacks to the heavy state intervention in response to the banking crisis. Yet there was no other alternative, and there is little doubt that the Government's resolute action in October last year staved off a confidence crisis that could have had serious consequences for the entire Norwegian economy. Stability has been restored, but the crisis will remain unresolved until the banks are in a position to raise capital on the private market on normal market terms.

Times have changed

So far we have responded to economic difficulties with traditional instruments or measures that we have been forced to take. But the economy no longer functions in the traditional way, nor can it be expected to do so. There are in

particular four factors which contrast the present situation with that which applied well into the 1980s.

- Real interest rates have turned positive at an international level, post-tax aswell as pre-tax
- Capital movements have been liberalised
- We have made a firm commitment not to respond with devaluations
- Our labour costs have risen yet another notch compared with other countries, and we have lost market shares at home and abroad.

The foreign exchange regulations no longer had the intended effect, and we could no longer retain a system that was being dismantled in trading partner countries. As a result, Norwegian interest rates are determined by the interest rates prevailing in international markets. Tax-based subsidisation of lending has been reduced substantially, and, by the same token, the undesired distributive effects of the former system have been corrected. The decision to maintain a stable international value of the krone had already been taken under the basket regime and is not the result of the linkage of the krone to the ecu.

A common assertion is that recent developments have reduced our freedom of action in economic policy decisions. Although true in a sense, this does not mean that we could have continued on our previous path since we had reached a dead end. We had to choose another avenue.

The question may be raised of what kind of benefits this freedom of action conferred, and still confers, on us. The regulatory mechanism and the tax system were helpful in protecting special interests and concealing the associated costs. The tax system still offers such shelter, and may offer even more depending on what modifications are made to the system. Devaluations allowed us to defer the problems at hand, and for another few years this can still be done via our fiscal policy. Assessing the pros and cons of using such freedom of action is just as important as determining what freedom of action actually exists.

As I have already indicated, the current framework conditions have dampened the impact of an expansionary fiscal policy stance on demand. Although some factors may prove ephemeral, the higher real after-tax interest rate indicates the emergence of a more permanent change, implying that an expansionary fiscal policy will increasingly tend to raise private sector assets. A share of this will be absorbed by the state's need to finance its deficit, and, as long as low returns on capital yield low capital demand, a major share will be invested abroad.

Furthermore, the demand generated through fiscal policy measures will create fewer jobs than previously. For import-competing industries the share of foreign imports increased from 38% to 48% in the period 1983-1991, or by more than one fourth. An expansionary fiscal policy will, therefore, to a larger extent than previously boost demand for foreign goods. Our export shares have not kept pace. To the contrary, our share of export markets has declined. Thus it would appear that the heavier import component of demand is attributable to a weakening in our competitive position, rather than increasing integration.

Since we last pursued a countercyclical policy, rising labour costs have further undermined the intended impact of our own measures to improve employment. The situation could be exacerbated should the integration process entail a further loss of domestic market shares, without a corresponding improvement in export markets. Fortunately there is no law of nature that rules out an adjustment of labour costs to a change in economic conditions.

Since the external account is running large surpluses and inflation is lower than in most other countries, it is understandable that unemployment is the main focus of economic policy. Although the policy measures we have used previously, and have again applied on an even larger scale, do not serve the intended objective, there is no reason why the authorities should accept the prevailing unemployment rate. However, the scope for combating unemployment by stimulating demand is limited. In the somewhat longer run this approach may only make things worse. The authorities have, however, other means at their disposal, such as revising rules which cause rigidity in the labour market or enhancing the efficiency and qualifications of the workforce.

Unemployment is nevertheless broadly unaffected by whether or not it is accepted by the authorities. With the framework conditions applying in our mixed economy, it is developments in the private sector which in the longer run will determine the level of employment.

Therefore, the question of whether or not the current unemployment level can be accepted must first of all be put to the social partners and their organisations. The answer must come in deed, not in words. The forthcoming wage settlement offers a good opportunity to provide an answer.